

REPORT BY THE
AUDITOR GENERAL
OF CALIFORNIA

**A REVIEW OF THE DEPARTMENT OF
CORRECTIONS' PROGRAM MANAGEMENT
AND CONSTRUCTION MANAGEMENT
CONTRACTS**

REPORT BY THE
OFFICE OF THE AUDITOR GENERAL

P-569

A REVIEW OF THE DEPARTMENT
OF CORRECTIONS' PROGRAM MANAGEMENT
AND CONSTRUCTION MANAGEMENT CONTRACTS

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Auditor General

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P-569

Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning the Department of Corrections' inadequate preparations for negotiating contract rates with the department's program management and construction management firms. The report also points out that the department is not ensuring that its program manager is fulfilling its responsibilities to deliver cost control reports to the department on schedule.

Respectfully submitted,

Thomas W. Hayes
THOMAS W. HAYES
Auditor General

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SUMMARY

RESULTS IN BRIEF

The Department of Corrections (department) is not adequately preparing for contract negotiations with its program management and construction management firms. Consequently, the department has agreed to rates for two of its contractors that are higher than justified based on the contractors' costs of providing services. Our calculations show that, for 2 of 6 program management and construction management contracts for fiscal years 1984-85 and 1985-86, the department could have saved \$941,000 while still providing a reasonable rate of profit to the contractors. In addition, the department does not ensure that its program management firm is fulfilling its responsibilities to deliver cost control reports on schedule.

BACKGROUND

The department's Planning and Construction Division is responsible for the planning and construction of ten new prisons and for additions to four existing prisons by 1991. The department employs Kitchell/CEM, Inc. (Kitchell), a program management firm, to assist in managing the prison construction program. During fiscal years 1984-85 and 1985-86, the department also contracted with ten architectural-engineering firms to prepare designs, drawings, specifications, and other contract documents and with five construction management firms to oversee the construction of each project. During fiscal years 1984-85 and 1985-86, the department paid Kitchell, the ten architectural-engineering firms, and the five construction management contractors a total of \$29.9 million.

PRINCIPAL FINDINGS

The Department's Preparation for Negotiations Is Inadequate

Department staff are inadequately preparing to negotiate compensation rates with either the department's program management firm or its construction management contractors. Before negotiations, the department's staff are not developing independent estimates of the value of the contractor's services nor determining fair and reasonable compensation rates. As a result, department negotiators have agreed to compensation rates that are higher than justified based on the consultant's cost of providing services. To calculate rates that we considered to be fair and reasonable, we used the contractor's costs, as determined by the department's internal auditor, plus a 12 percent allowance for profit. Had the department negotiated rates equal to the amounts we calculated for four of the five contract negotiations that we examined, the department would have saved \$941,000 in payments to these contractors during fiscal years 1984-85 and 1985-86.

The Department's Program Management Firm Is Not Delivering Cost Control Reports as Required

The department's program management firm has not delivered cost control reports to the department as frequently as its agreement with the department requires. Further, 66 percent of the reports for two projects in our sample were delivered an average of 12.8 days late. Because the program management firm did not fulfill its responsibilities to deliver these reports on schedule, department managers may be making decisions based on out-of-date information. The department's project directors to whom the program management firm delivers the cost control reports have not always enforced the requirement that cost control reports be delivered on time.

RECOMMENDATIONS

To ensure that it negotiates compensation rates that are fair to the State and to the consultant contractors, the department should prepare for the negotiations with its contractors by developing its own estimate of the value of the services to be provided by the contractors. This estimate should be based on the best information that the department has available, which may be the rates charged by other contractors for similar work or the audited cost to the contractor for providing services to the department.

To ensure that the program management firm complies with the department's requirement to deliver periodic cost control reports, the department should ensure that its project directors consistently enforce this requirement and notify the firm in writing whenever reports are not delivered on time.

AGENCY COMMENTS

The Youth and Adult Correctional Agency agrees to immediately implement our recommendations. However, it does not concur with all of our findings and conclusions. The agency believes that the report inaccurately implies that the Department of Corrections' was not adequately prepared for negotiations with all of its program and construction management contracts. The department points out that we reviewed negotiations for extensions to existing contracts, not negotiations for new contracts. Further, the agency disagrees with our finding that contract rates are too high because part of our analysis consists of a comparison of rates that the department negotiated with rates that the federal government negotiated in a contract for similar services. The agency contends that the scope of the federal contract was much different from the scope of the department's program management contract. In addition, the agency explains that it is not the department's practice to set new rates for amended contracts by merely adjusting those rates for inflation.

Finally, the agency states that the reason for the delay in the delivery of the cost control reports was that the department directed the contractor to do other, more important work.

See page 33 for our comments on the agency's response.

INTRODUCTION

The Department of Corrections (department) is responsible for the control, care, and treatment of persons whom the courts have convicted of serious crimes and committed to state correctional institutions. The department operates 42 institutions throughout the State, including 12 prisons and, in cooperation with the Department of Forestry and Los Angeles County, 30 conservation camps.

To accommodate the anticipated increase of inmates into the State's correctional system, the department's immediate plan is to increase prison capacity to house an additional 16,500 inmates. Chapter 11, Section 7000 et seq., Title 7, Part 3, of the Penal Code assigns to the department the responsibility for planning, designing, and constructing prison facilities identified in the department's master plan. The department's Planning and Construction Division is responsible for the planning and construction of ten new prisons and the additions to four existing prisons by 1991.

Since 1982, the department has contracted with one program management firm and a number of architectural-engineering management firms to assist in constructing new prisons. To obtain assistance in planning new prisons and managing their construction, the department has contracted with Kitchell/CEM, Inc. (Kitchell), or its predecessor, Rosser-Kitchell, since July 1982. In fiscal years 1984-85 and 1985-86, the department paid Kitchell approximately \$7.1 million. The

department also contracts with architectural-engineering firms, which prepare the design drawings and specifications for the construction of new prison facilities. During fiscal years 1984-85 and 1985-86, the department contracted with ten architectural-engineering firms and, during that period, paid them a total of \$17.1 million. The department also contracts with construction management firms to oversee the construction of new prison facilities. During fiscal years 1984-85 and 1985-86, the department contracted with five construction management firms and paid them a total of \$5.7 million. During fiscal years 1984-85 and 1985-86, the department compensated Kitchell, the architectural-engineering firms, and the construction management contractors a total of \$29.9 million. Most of the 16 firms that are currently under contract to the department have had contracts with the department that are amended to extend the term of the contract and the amount to be paid to the contractor.

The department's contracts with Kitchell and the construction management firms establish an hourly rate for each category of the contractor's employees who will be providing services to the department. For example, a contractor's staff may include engineers, architects, and planners. The department reimburses the contractor one rate for engineers, a different rate for planners, and a third rate for architects. In addition to paying the contractor for the services that its staff provide, the department also reimburses the contractor for the cost of certain additional expenses that the department allows, such as the cost of travel, data processing, or special consultants.

The Government Code, Section 4525 et seq., requires that the director of the department select the architectural-engineering firms on the basis of their demonstrated competence and professional qualifications. The Attorney General's Office has determined that this law can also apply to the selection of firms for construction management services. Therefore, the director has applied Government Code, Section 4525 et seq., in the award and negotiation of specific contracts for construction management services. Moreover, the law requires the director to evaluate statements of "qualifications and performance data" from interested firms and to select at least three firms, in order of preference, whom the director deems to be the most highly qualified to provide the services required. The director's selection of the three firms is to be based upon criteria that he or she has established and published. The director must then negotiate with the best qualified firm a contract that establishes an amount of compensation that the director determines is fair and reasonable to the State.

SCOPE AND METHODOLOGY

We reviewed numerous aspects of the department's new prison construction program. In this report, we discuss the department director's procedures for negotiating rates with the department's program management and construction management contractors, and we discuss the program management contractor's fulfillment of its contract with the department.

To determine whether the department negotiated reasonable rates with its program management and construction management contractors, we reviewed the department's estimates and internal audit reports. We also interviewed federal officials and representatives of the Office of the State Architect to determine how they negotiate and award contracts.

To determine whether the department's program management contractor was fulfilling its contractual responsibility to deliver important management reports, we reviewed the reports that the program manager was required to deliver for two new prison construction projects--San Diego and Avenal.

In our review of the following components of the new prison construction program, we found few weaknesses. We reviewed the department's procedures for advertising, evaluating, and awarding program management, construction management, architectural-engineering, and construction contracts. We also evaluated the language in various types of contracts as well as the department's methods for managing its contractors, including its program management and architectural-engineering contractors. We also performed audit work at two new prison construction sites to review the department's management of its construction management and construction contracts. While at these sites, we tested the procedures that the department and the construction managers use to determine the necessity for changing construction-related orders and for establishing reasonable prices. We

also tested the construction manager's procedures for ensuring the construction contractor's adherence to the construction schedule. In addition, we tested the procedures for inspecting the contractor's work used by the Office of the State Architect and the construction manager.

We also evaluated the department's procedures for approving and paying invoices associated with the new prison construction program. As part of this evaluation, we reviewed the necessity and reasonableness of a sample of expenditures made by the department during fiscal year 1985-86.

We also determined whether there was duplication of effort among the various personnel working on the new prison construction program. We determined who was responsible for specific tasks--the program manager, architect-engineer, construction manager, construction contractor, Office of the State Architect, or department staff--and whether there was overlap among these tasks.

Our review also included an evaluation of the department's controls over purchasing, receiving, accounting, and storing equipment at the new prison sites. Finally, we evaluated the department's methods for projecting the number and the security level of beds that it will need to meet the growth in the inmate population.

AUDIT RESULTS

I

THE DEPARTMENT OF CORRECTIONS IS NOT ADEQUATELY PREPARED WHEN IT NEGOTIATES ITS CONTRACTS WITH EITHER ITS PROGRAM MANAGEMENT FIRM OR ITS CONSTRUCTION MANAGEMENT FIRMS

Staff in the Department of Corrections (department) are not adequately prepared when they negotiate contract terms with either Kitchell/CEM, Inc. (Kitchell), the department's program management firm, or the department's construction management firms. Before negotiating with contractors, department staff are neither preparing estimates of the value of the services that these firms will be providing nor determining fair and reasonable compensation rates. Consequently, the department's negotiators have agreed to rates that are higher than justified based on the cost to the consultant of providing services. During fiscal years 1984-85 and 1985-86, the department would have saved approximately \$941,000 if, for four of the five contracts we reviewed, it had negotiated rates that we calculated to reflect the contractor's cost of providing services plus a reasonable amount for profit.

Established Practices in Preparing To Negotiate With Contractors

According to the California Administrative Code, Title 15, Section 3459, the department is required to determine an estimated

value of services before it negotiates a contract. An estimated value of services takes into consideration the types of skills that the firm's employees will provide to the department and the firm's hourly billing rate for each category of skilled employees, such as architects, engineers, planners, and other employees. The department must also estimate the number of hours of services for each employee category that the department will use during the term of the contract. The hourly billing rate represents three elements: the salary and benefits of the employee who is providing services, the firm's overhead, and an amount for profit. Employee benefits include expenses such as payroll taxes, life and disability insurance, health insurance, vacation, holidays, sick leave, and retirement. Overhead costs are those costs that are not easily identified with any one of the contractor's projects. For example, the cost to the contractor of maintaining a headquarters office is an overhead cost that is absorbed by each of the contractor's projects. According to the State Administrative Manual, Section 1243, the compensation that state departments pay to consultant contractors should be based on the complexity and difficulty of the project and the prevailing rate for similar work both within and outside state service.

At the Office of the State Architect (OSA), which negotiates and awards numerous contracts each year, the administrative manager of support services informed us that, before negotiating with a prospective contractor, OSA staff prepare an estimate of the value of the services that the contractor will be providing. To do this, the

OSA determines the types of services and personnel that will be required of a prospective contractor, the number of labor hours that will be required, and reasonable hourly rates for the services needed. These hourly rates include an allowance for overhead and profit. To determine the reasonableness of these rates, the OSA reviews what it has recently paid other firms for similar work. From this analysis, the OSA formulates an estimate of the value of the contractor's services. To this estimate, the OSA adds 10 percent, establishing the upper limit of compensation that the OSA will agree to pay the contractor for its services. The OSA also requests a cost proposal from the contractor and compares this to the OSA's independent estimate. If the contractor's cost proposal exceeds the OSA's estimate, then the OSA begins discussions with the contractor to resolve the differences. If the contractor's proposal falls more than 10 percent below the OSA's estimate, the OSA begins discussions with the contractor to ensure that the contractor has not underestimated the resources that the OSA believes should be committed to the proposed project.

Finally, federal regulations prescribe similar methods for federal agencies to follow. Before beginning negotiations with architectural-engineering firms, federal agencies are required to prepare an independent estimate of the cost of the services they require. The federal agency's independent estimate is equivalent to the OSA's estimate of the value of services previously discussed. The independent estimate identifies the types of services and personnel

that will be required from a prospective contractor, the number of labor hours that will be required, and reasonable hourly rates for the services needed.

We interviewed contracting officials at the United States General Services Administration (GSA) in San Francisco, who negotiate architectural-engineering and construction management contracts. They stated that they adhere to the federal regulations discussed above. In addition, for contracts that are expected to exceed \$500,000, they also audit the contractor's financial records to determine the contractor's costs for providing services, such as the costs of salaries, benefits, and overhead. Then, based on this independent estimate, the GSA's detailed review of the contractor's price proposal, the auditor's report of the contractor's costs, and a review of what the GSA has paid other contractors for similar work, the contracting agency is required to establish "prenegotiation objectives," which include the contracting agency's determination of fair compensation for the services that are being sought. The federal regulations recognize that, by establishing prenegotiation objectives before negotiations begin, the contracting agency is in a better position to judge the overall reasonableness of a contractor's price proposal.

The Department Has Not Sufficiently
Prepared for Negotiations With Consultants

During fiscal year 1984-85, the department had contracts in effect with Kitchell and two construction management firms. During 1985-86, the department had contracts with Kitchell, the same two construction management firms, and three new construction management firms. The department awarded contracts and contract amendments to these six firms that amounted to \$29.6 million. We reviewed the department's negotiation of five amendments to three of these contracts. Two of these amendments, whose value totaled nearly \$11.5 million, extended the department's contract with Kitchell, the program management consultant. Two of the amendments, totaling over \$7.1 million, extended the contract of Heery/Vanir, Inc., a construction management firm and one of the amendments, for over \$872,000, extended the contract of O'Brien-Krietzberg and Associates, Inc., a construction management firm.

For four of the five negotiations that we reviewed, the department did not estimate a reasonable value for the contractor's services based on the types of services that would be required, the number of labor hours that would be required, or reasonable billing rates for each employee category. For these four negotiations, the department staff negotiating the amendments had a report from the department's internal auditor that specified the costs to the contractor of providing services to the department during the period covered by the audit. These costs included the salaries and benefits

of those contractor employees who would be assigned to work for the department, the contractor's overhead, and items such as travel, employee relocation, and data processing services. However, the department did not use this information, or any other sources of cost data to estimate the value of the contractor's services. Rather, the deputy director for the Planning and Construction Division explained that the department and the contractor agreed on new hourly rates based on the rates established in the existing contract. In effect, the department and the contractor merely negotiated an increase in the contractor's hourly rates to adjust for the effects of inflation from one contract period to the next.

The department's method of amending contracts also contrasts with the procedures followed by the OSA and federal agencies, in which the contracting agency independently prepares estimates of the value of services to be provided by the contractor and, based on this and other information, establishes prenegotiation objectives. The OSA and federal agencies follow these procedures whether they are negotiating a new contract or an amendment to an existing contract. In addition, if the department anticipates that a contractor will be needed for subsequent phases of a project, the department may award the contract in phases by including a provision in the initial contract that the term of the contract may be extended. When the department does contract in phases, Title 15 of the California Administrative Code requires that the department prepare an estimated value of the contractor's services.

In past negotiations, the department has been criticized by its own internal auditors for not doing the type of preparation and research that is required to ensure that the department negotiate reasonable rates with its consultants. In an audit report covering Kitchell's contract with the department, the auditors concluded that, because the department is not adequately prepared for negotiations, Kitchell's rates may be overstated.

Contract Rates Are High

Because department staff have not adequately prepared for their negotiations with contractors, the contract rates they have agreed to are greater than justified based on the cost to the contractor of providing services. We computed an estimated value of services for four of the five negotiations in our sample for which audited financial information was available to the department during negotiations. In these four cases, the department negotiated hourly rates that were, in most cases, higher than the hourly rates we calculated. To calculate the hourly rates, we used the salary and overhead cost information from the department's most current audit report. Our calculation also includes the negotiated employee benefits rate that was in effect at the time of the negotiations: 35 percent of salary cost during the 1984-85 negotiations and 40 percent of salary cost during the 1985-86 negotiations. We adjusted the salary, benefits, and overhead for inflation and allowed an additional 12 percent for profit. Since audited financial information was not

available for the fifth negotiation, we compared the contractor's billing rates to the rates charged by other construction management contractors that are providing similar services to the department. From this comparison we concluded that the billing rates that the department negotiated were close to what other construction management firms are billing for construction management services.

Based on discussions with federal contracting officials, we determined that a reasonable allowance for profit for architectural-engineering and construction management contracts is between 10 and 12 percent of the consultant's costs. Contracting officials in the San Francisco office of the United States General Services Administration (GSA), who negotiate numerous architectural-engineering and construction management contracts, told us that they seldom allow architectural-engineering and construction management contractors a profit rate that exceeds 12 percent of the contractor's cost. For example, on two contracts that the GSA awarded for architectural-engineering and construction management services during fiscal year 1985-86, the GSA allowed both contractors profits that equalled 11 percent of costs.

When we compared the rates that we computed for the four contract amendments to the rates that were actually negotiated, we found that the negotiated hourly rates for 42 of the 48 job categories in the four negotiations were higher than those that we computed. For example, in all ten job categories, the negotiated rates in the 1984-85

Kitchell contract amendment were an average of 11.7 percent higher than the rates we computed. Further, using only comparable job categories, we compared the rates in the 1985-86 amendment to the Kitchell contract to the rates that the GSA allowed in two of its 1985-86 contracts for similar work. These job categories constitute over one-half of the hours billed to the department in fiscal year 1985-86. Again, the rates in the Kitchell contract were higher than the hourly rates of the GSA contractors in all but one instance. Table 1 compares the rates for the 1985-86 amendment of the department's contract with Kitchell to the rates we calculated and to the rates negotiated by the GSA for two of its contracts.

TABLE 1

**A COMPARISON OF PAID AND CALCULATED CONTRACT HOURLY RATES
 DEPARTMENT OF CORRECTIONS
 OFFICE OF THE AUDITOR GENERAL
 GENERAL SERVICES ADMINISTRATION
FISCAL YEAR 1985-86**

<u>Job Category</u>	Department Rates Paid to Kitchell	Auditor General Calculated Rate	GSA Rates Paid to a No. Calif. Contractor	GSA Rates Paid to a So. Calif. Contractor	Average of Auditor General and GSA Rates	Difference Between Average and Rate Paid to Kitchell
Principal	\$137.00	\$113.89	\$125.51	\$89.63	\$109.68	24.9%
Electrical Engineer	\$ 76.00	\$ 68.43	\$ 60.00	\$52.14	\$ 60.19	26.3%
Mechanical Engineer	\$ 76.00	\$ 68.43	\$ 60.00	\$52.14	\$ 60.19	26.3%
Civil Engineer	\$ 76.00	\$ 68.43	\$ 54.61	\$52.14	\$ 58.39	30.2%
Architect	\$ 71.00	\$ 68.43	*	\$42.02	\$ 55.23	28.6%
Scheduler	\$ 66.00	\$ 57.95	\$ 41.15	*	\$ 49.55	33.2%
Cost Estimator	\$ 66.00	\$ 57.95	\$ 41.15	*	\$ 49.55	33.2%
Clerical	\$ 27.00	\$ 31.08	\$ 28.28	\$26.46	\$ 28.61	(5.6%)

*These rates were not available.

As Table 1 shows, the rates paid to Kitchell for seven of the eight job categories we compared were at least 24.9 percent above the average of the rates we calculated and the rates paid by the GSA to two contractors. If, for the four negotiations that we reviewed, the department had negotiated the same hourly rates we computed, the department would have saved approximately \$941,000 during fiscal years 1984-85 and 1985-86.

We did not obtain comparable rates for other government agencies that have contracts with construction management firms. However, in Table 2, we compare the rates that the department awarded to Heery/Vanir, Inc., one of the two construction management firms in our sample, to the rates that we calculated based on the cost to Heery/Vanir of providing services to the department and a 12 percent profit factor.

TABLE 2

**RATES PAID TO HEERY/VANIR, CONSTRUCTION MANAGER,
COMPARED TO RATES CALCULATED BY THE AUDITOR GENERAL
FISCAL YEARS 1984-85 AND 1985-86**

Job Category	1984-85			1985-86		
	Rate Paid to Heery	Rate Calculated by the Auditor General	Difference	Rate Paid to Heery	Rate Calculated by the Auditor General	Difference
Principal	\$108.68	\$105.06	3.4%	\$115.20	\$103.22	11.6%
Project Director	\$ 98.85	\$ 97.50	1.4%	\$104.78	\$ 90.63	15.6%
Deputy Project Director	\$ 77.34	\$ 84.69	(8.7%)	\$ 81.98	\$ 74.57	9.9%
Construction Manager	\$ 78.17	\$ 69.41	12.6%	\$ 75.75	\$ 70.37	7.6%
Project Manager	\$ 77.34	\$ 70.47	9.7%	\$ 81.98	\$ 74.57	9.9%
Assistant Construction Manager	\$ 65.78	\$ 69.41	(5.2%)	\$ 68.97	\$ 62.04	11.2%
Scheduler	\$ 62.40	\$ 69.07	(9.7%)	\$ 65.41	\$ 48.59	34.6%
Estimator	\$ 62.40	\$ 55.71	12.0%	\$ 65.41	\$ 55.01	18.9%
Data Processing	\$ 35.16	\$ 26.82	31.1%	\$ 36.84	\$ 25.03	47.2%
Field Secretary	\$ 22.67	\$ 22.70	(0.1%)	\$ 23.78	\$ 20.96	13.5%

As Table 2 shows, in fiscal year 1984-85, only three of Heery/Vanir's billing rates exceeded the rates calculated by the Auditor General's Office by more than 10 percent. However, in fiscal year 1985-86, seven of the ten billing rates exceeded the rates calculated by the Auditor General's Office by more than 10 percent.

The Department's Rationale
for the High Rates

We presented our calculations to the department's deputy director for planning and construction and to the department's negotiators and asked them to explain why the department has not developed independent cost estimates and prenegotiation objectives and why the negotiated rates were higher than the rates that we computed using the cost information in audit reports. They responded that they do not use the audit reports as the basis for computing contract rates because the contractor's costs presented by the auditor are subject to change. According to department staff, the contractor may appeal to a departmental review committee any cost items that the auditors did not include in their statement of the contractor's cost. The consultant may also provide additional evidence that convinces the auditors that a cost item that the auditors initially omitted was appropriate. However, we believe that the possibility of changes to the auditor's cost information should not inhibit the department from considering this information in developing independent cost estimates, since the audits provide only part of the total information that the department should evaluate in developing its prenegotiation objectives.

In addition, the deputy director for the Planning and Construction Division explained that the contractor's negotiated rates are higher than the rates that we computed because of the approach that the department takes in negotiating an amendment to an existing contract. He objected to our computing a set of rates based on the

audit report and then suggesting that these rates should be the department's prenegotiation objective because this approach would require that the department negotiate rates for a contract amendment in the same way that it negotiates rates for a new contract. He also informed us that the department bases a new set of rates on the contractor's rate structure from the previous contract. Using this approach, the department's negotiators attempt to negotiate new rates that approximate the contractor's current rates plus an allowance for inflation, which is equal to the cost-of-living increase that is to be awarded to state workers that fiscal year. However, the department had no written record of these calculations or of this negotiation strategy.

We do not agree with this approach to negotiating contract rates; in addition, we found that the deputy director's explanation was not accurate. For two of the five negotiations in our sample, the negotiations with Kitchell in fiscal years 1984-85 and 1985-86, the rate increases that resulted from the negotiations were greater than the cost-of-living increases that state workers received in all but two instances. From fiscal year 1982-83 to fiscal year 1985-86, the cost-of-living increase awarded to state employees ranged from 21.3 to 30.5 percent. We compared this range to the total increases in the rates awarded to Kitchell for each billing category from fiscal year 1982-83 to fiscal year 1985-86. Our results are presented in Table 3.

TABLE 3

**RATE INCREASES NEGOTIATED WITH KITCHELL
COMPARED TO THE COST-OF-LIVING ALLOWANCES
AWARDED TO STATE EMPLOYEES
FISCAL YEARS 1982-83 THROUGH 1985-86**

<u>Billing Category</u>	<u>Actual Rate Increase</u>	<u>Cost-of-Living Allowance Awarded to State Employees</u>	<u>Difference</u>
Principal	71.3%	21.9%	49.4%
Estimator	46.7%	21.3%	25.4
Scheduler	46.7%	21.3%	25.4
Operations Manager	24.6%	21.9%	2.7
Engineer	26.7%	21.3%	5.4
Planner	55.6%	21.3%	34.3
Architect	1.4%	21.3%	(19.9)
EDP Manager	45.5%	21.9%	23.6
EDP Operator	(5.7%)	21.3%	(27.0)
Clerical	35.0%	30.5%	4.5

As Table 3 shows, in eight of ten billing categories, the department negotiated rates that were higher than increases awarded to state employees.

The department offered a third explanation as to why negotiated rates were higher than the rates we computed using the cost information in the department's audit reports. According to the department, in some instances, the department is willing to pay a premium rate for an individual on the consultant's staff who is uniquely qualified. We agree that this can be a valid reason for paying a premium rate. However, the department has been unable to furnish any information on who these individuals are or what unique qualifications they possess that justify a premium rate.

CONCLUSION

For four of the five negotiations that we reviewed, the Department of Corrections is paying the consultants rates that are higher than the rates we calculated using the audited cost information and a 12 percent profit rate. In our opinion, one reason for the department's higher rates is that the department did not sufficiently prepare for the negotiations with its consultants by determining its own estimate of the value of the services to be provided by the consultants and by establishing prenegotiation objectives. Rather, in negotiating amendments to the consultant's contract, the department's deputy director for the Planning and Construction Division maintains that it negotiated new rates based on the contractor's existing billing rates. In effect, the department is merely negotiating a cost-of-living adjustment to the consultant's existing rates. We found, however, that the changes in the contractor's billing rates differed significantly from cost-of-living increases received by state workers.

RECOMMENDATIONS

To ensure that it negotiates consultant rates that are fair to the State and to the consultant, the Department of Corrections should prepare for negotiations with its consultants by

preparing its own estimate of the value of services to be provided by the consultants. This estimate should be based on the best information that the department has available, including the rates charged by other consultants for similar work or the actual cost to the consultant for providing services to the department.

The department should then establish a prenegotiation objective, or the department's determination of fair compensation for the services that are being sought. The department's prenegotiation objective should be based on the department's estimated value of services, the department's detailed review of the contractor's price proposal, the auditor's report of the contractor's costs, and the department's determination of the prevailing rates for similar services.

II

THE DEPARTMENT OF CORRECTIONS IS NOT ENSURING THAT ITS PROGRAM MANAGEMENT FIRM PROMPTLY DELIVERS COST CONTROL REPORTS

Kitchell/CEM, Inc. (Kitchell), the department's program management contractor, has not delivered cost control reports to the department as frequently as its agreement with the department requires. Further, 66 percent of the reports for two projects we reviewed were not delivered within the time limits that the department requires. Because Kitchell is not fulfilling its responsibilities, department managers may be making decisions based on out-of-date information. The department's project directors have not always enforced the requirement that Kitchell deliver cost control reports.

As part of its contract with the department, Kitchell provides the department with cost control reports for each construction project. The department currently has ten new projects underway. Seven projects are under construction or near completion, and three projects are in the planning stage. The cost control reports contain budget data, expenditure data, and projected expenditure data that help department managers monitor a project's financial status throughout the planning, design, and construction stages of the project.

According to the assistant deputy director for the Planning and Construction Division, the department had an informal agreement

with Kitchell regarding the delivery of cost control reports until August 18, 1986, when this agreement was formalized in a memo of understanding. The department's agreement with Kitchell requires Kitchell to update and deliver a cost control report within 48 hours of a contract award for a specific segment of the project construction, within 48 hours of some other significant change to a project, or at least once a month. One of the two Kitchell project managers who were responsible for delivering cost control reports for the projects in our sample agreed that the cost control reports are to be delivered to the department at least once a month or when there is a significant change on a project.

During the six-month period from January 1, 1986, to June 30, 1986, Kitchell delivered only three cost control reports for the Avenal project, a new 3,000 bed prison in King's County. Kitchell should have delivered at least six, one for each month of the six-month period. For both the San Diego and Avenal projects, the department awarded nine construction contracts between January 1, 1986, and June 30, 1986. Kitchell did not provide six of the nine cost control reports (66.6 percent) within the required 48 hours of each contract award. The six reports were delivered an average of 12.8 days late.

In addition, during our review of Kitchell's cost control reports, the department's project director for the Northern California Women's Facility (NCWF) informed us that Kitchell was delivering cost control reports late. Also, the Kitchell cost control report dated

June 16, 1986, for the NCWF did not contain the information that the project director requested. Both the project director and the assistant deputy director of the Planning and Construction Division asked Kitchell to revise the cost control report for the NCWF on June 17, 1986, and again on August 11, 1986. However, Kitchell did not deliver a revised cost control report for NCWF until September 8, 1986, nearly 90 days after the department's project director first requested the report. According to a department's project director, Kitchell is also required to submit cost control reports at the request of a project director.

Because the cost control reports reflect the latest cost estimate for a project, the department staff use the reports to determine if additional funds may be needed to complete the project. If Kitchell does not promptly deliver accurate cost control reports, department managers may make inappropriate decisions because they do not have the most current fiscal information. The department's project directors to whom Kitchell delivers the cost control reports have not always enforced the requirement that Kitchell deliver cost control reports. Also, the department could provide no evidence that it has notified Kitchell that these reports are not being delivered in accordance with its contract.

According to one of the department's project directors, one of Kitchell's project managers responsible for delivering the cost control reports did not have time to do this because he was busy preparing documents for bids on new construction contracts.

CONCLUSION

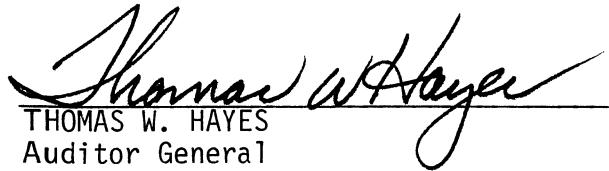
Kitchell either did not deliver or did not promptly deliver cost control reports to the department. Without these cost control reports, the department may be making decisions regarding new prison projects without the most current fiscal information. The department's project directors have not always required that Kitchell deliver these reports in accordance with its contract.

RECOMMENDATION

To ensure that Kitchell delivers the required periodic cost control reports, the Department of Corrections should ensure that its project directors consistently enforce the requirement that Kitchell deliver cost control reports and notify Kitchell in writing whenever reports are not delivered promptly.

We conducted this review under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,



THOMAS W. HAYES
Auditor General

Date: January 26, 1987

Staff: Steven L. Schutte, Audit Manager
Steven M. Hendrickson
Margaret A. Peters
Frank D. Cooper
Rene Gutierrez
Matthew Loveland

Memorandum

Date : January 20, 1987

Telephone: ATSS ()
()

To : Mr. Thomas W. Hayes, Auditor General
Office of the Auditor General
660 J Street, Suite 300
Sacramento, CA 95814

From : **Youth and Adult Correctional Agency**
Office of the Secretary

Subject: RESPONSE TO DRAFT REPORT ON NEW PRISON PROGRAM MANAGEMENT AUDIT

Thank you for the opportunity to comment on your draft report entitled "A Review of the Department of Corrections' Program Management and Construction Management Contracts". While your final report is directed to findings in the area of four of our consultant contracts, we appreciate the time and effort your staff put into reviewing many other areas of our program. I am pleased to note that after approximately one year of audit activity in this unprecedented \$2 billion construction program that you stated "In our review of other components of the new prison construction program, we found few weaknesses."

You indicate that your audit scope included reviews of the following:

1. Procedures for advertising, evaluating, and awarding program management, construction management, architectural/engineering, and construction contracts.
2. Contract language
3. Department procedures for managing contractors
4. Construction site review of the Department's procedures to manage the construction managers and construction contracts
5. Change order necessity and pricing
6. Construction manager's procedures for schedule management
7. On-site inspection procedures
8. Invoice payment procedures
9. Testing of expenditures for necessity and reasonableness
10. Duplication of effort between the Department and contract consultant staff

11. Purchasing, receiving, accounting and storage of new prison equipment
12. Population projection procedures

As this \$2 billion program involves the expedited construction of fourteen new prison projects and approximately 26,000 new beds, essentially doubling the size of our current prison system over the next two years, we are very pleased that the identifiable weaknesses in our many processes are only in one of these areas and limited to a small portion of our consultant contracts. (1)*

While we do not concur with all of the findings and conclusions, we feel your staff have made very positive recommendations which the Department will immediately implement to strengthen procedures and improve documentation.

Regarding the specific findings presented in your report, we would like to offer the following comments and information:

Audit Finding:

The Department of Corrections (CDC) is not adequately prepared when it negotiates its contracts with either its program management firms or its construction management firms.

CDC Response:

The Department concurs that improvements can be made to strengthen and improve the negotiation procedures. However, we feel it is inaccurate to imply that this finding is equally applicable to all program management or construction management contracts. It is important to note that the four contracts identified in this finding are extensions of existing contracts. While the Department's procedures at that time for contract extensions involved the development of negotiating positions based on various data, including audit reports, contractor documents, projected prison construction schedules, and other information available to the negotiators, the quantification and documentation was not as stringent as was being applied to new contractors. This will be strengthened for future negotiations. (2)

Audit Finding:

The Department's negotiators agreed to rates that are higher than justified for four of the five contracts reviewed.

CDC Response:

The Department disagrees with this finding. It is important to note that this contract is for broad program management services essential to the oversight and control of the \$2 billion new prison construction program. As stated in the audit, the State Administrative Manual specifies that compensation should be based on the complexity and difficulty of the project and the prevailing rate for similar work, both within and outside State service.

*The Auditor General's comments on specific points contained in the Youth and Adult Correctional Agency's response begin on page 33.

It has been extremely difficult to identify a comparable service being performed either inside or outside State service. The new prison construction program, both in magnitude and urgency, is substantially more complex, critical, and urgent than other programs which were reviewed. The relative magnitude, complexity and consequence of the problems dictate that our technical capabilities be of the highest caliber. The closest comparison the Department was able to identify was at the Federal level and was apparently the same firm reviewed by the auditors. However, we seriously question the comparability as this firm is providing a very limited service (less than one tenth of the value of the new prison program management services contracts) and primarily provides technical services for relatively small remodeling projects. We feel it is inaccurate to compare services, skills, productivity and the resulting billing rates for minor remodeling work with those required for the effective management and control of a \$2 billion new prison planning and construction program. (3)

In our development of the program management contract, the Department initially established base salary rates for most positions at a level that was generally comparable to State employee salary rates. In each subsequent year contract extension negotiation, the resulting billing rate was reviewed and renegotiated. The information considered by the negotiators included prior period audit and financial data, proposed benefit packages, salary levels, State cost-of-living adjustments, projected staffing goals, and any other factors relevant to the companies' projected operating costs. In addition, other factors such as individual expertise, performance, productivity, and overall effectiveness were discussed. In several cases, these factors resulted in billing rates for specific individuals which were not included in the across-the-board calculation process utilized by the auditors to calculate rates. As commendable efforts by a number of our contract employees have resulted in program-wide savings in excess of \$100 million, it is important that these factors continue to be considered. However, in the future the Department will take steps to better document the basis for such negotiation positions.

The audit is not correct in the assessment that these extensions involve negotiations merely to increase the contractors hourly rates to adjust for the effects of inflation. While CDC does not reevaluate each of the consultant staff base salary levels during each extension period unless there is audit information identifying a discrepancy, a review of the multiplier, benefits, and cost-of-living factors is always performed and included in the negotiations. This is more restrictive than our understanding of the Federal procedures as the Federal contracts provide for extensions of the base contract adjusted only by a flat eight percent increase (which also exceeds cost-of-living adjustments). (4)

This process used by the CDC negotiators to develop contract extension billing rates has not resulted in adjustments that equal the increases provided through cost-of-living raises to State employees. For example, the 1985-86 contract extension for program management services involved adjustments to both salary and overhead expenses. The end result was an increase that was for most billing categories, about two percent less than State cost-of-living adjustments. (5)

Audit Finding:

The Department is not ensuring that its program management firm promptly delivers cost control reports.

CDC Response:

The Department concurs that cost control reports were often delayed or not delivered during the period of audit. It is important to recognize that during that period there was an extraordinary effort put forward to ensure that the planning and construction of the new prisons were expedited and brought back on schedule. This involved numerous decisions on the various priorities and use of resources. In many cases, individual reports that were deemed not be as critical as other work were delayed or deleted.

While this conscious decision making will continue in periods of necessity, such decisions will be better documented. It should be pointed out, however, that since the program management contract is structured as a fee for service contract, the consultant is not reimbursed if the services are not provided.

SUMMARY:

In summary, we are very pleased that the audit has identified few weaknesses in our procedures to manage this program. While we do not concur with the specific audit findings that some rates have been excessive, we do agree that it is necessary to better document the negotiations conducted with our consultants. Much of the success of this program in completing nearly 8,000 new beds to date with over 5,000 more scheduled to be completed by the end of fiscal year 1987 is attributed to the outstanding efforts by our consultants as well as our own staff. We feel this audit confirms our dedication to completing this program in as efficient and effective manner as possible and also offers some very positive recommendations which will further support this goal.

Again, thank you for the opportunity to comment. If you would like to discuss our comments, please contact Rodney J. Blonien, Undersecretary, at 3-6115.


N. A. CHADERJIAN
Agency Secretary

**AUDITOR GENERAL'S COMMENTS ON THE RESPONSE
OF THE YOUTH AND ADULT CORRECTIONAL AGENCY**

- (1) The Youth and Adult Correctional Agency asserts that the Auditor General reviewed only a "small portion" of the Department of Corrections' consultant contracts. This is not true. During fiscal years 1984-85 and 1985-86, the department paid a total of \$29.9 million to its consultant contractors. We reviewed the negotiations for five amendments to three of these contracts. These amendments represented \$19.5 million.
- (2) The agency believes that it is inaccurate for us to imply that the department is not adequately prepared for negotiating all program management and construction management contracts since we reviewed only the department's negotiations for extensions (amendments) to existing contracts, not the negotiations for new contracts. Also, the agency states that the department's procedures for negotiating new contracts are more stringent than its procedures for negotiating contract amendments. Therefore, according to the agency, it is unfair for us to characterize the department as being unprepared to negotiate new contracts as well as contract amendments. We do not agree that our conclusions are inaccurate.

Amendments to the department's contracts for program management and construction management services represent a greater dollar value than do the new contracts. During fiscal years 1984-85 and 1985-86, the department negotiated billing rates for three new contracts and ten contract amendments. The new contracts represented \$7.6 million, and the contract amendments represented \$21.4 million, 74 percent of the total value of the contracts of \$29 million. Since the department is obviously much more involved in negotiating contract amendments, we believe that the department should have procedures for negotiating contract amendments that are at least as stringent as the procedures for negotiating new contracts. However, after numerous requests, the department has been unable to provide us with any written procedures for negotiating either contract amendments or new contracts. Therefore, we believe that our recommendation to the department to prepare for contract negotiations by estimating the value of contractor services and then establishing prenegotiation objectives fairly addresses the department's negotiation of new contracts and contract amendments.

- (3) The agency believes that our comparison of the department's program management contract to two federal contracts for architectural, engineering, and construction management services is questionable.

We disagree with the agency for several reasons. First, both federal contracts that we refer to in the audit report are

contracts for architectural-engineering and construction management services on new construction as well as remodeling projects, not merely "minor remodeling work" as the department states. Second, the scope of work specified in the federal contracts is similar to the scope of work in the department's program management contract. In fact, many of the specific tasks outlined in the federal contracts are identical to the tasks assigned to the department's program manager. Third, the types of personnel and the minimum qualifications of the personnel in both the federal contracts and the department's program management contract are similar. In both the federal contracts and the department's contract, the key personnel are architects, engineers, and construction project managers.

We also wish to point out that the department sought to identify federal contracts comparable to their program management contracts only after we met with the department to discuss this audit finding. As our report points out, this type of comparative analysis should be done before the department begins negotiations with the consultant contractor.

- (4) The agency asserts that we incorrectly conclude that the department's negotiation of contract amendments was accomplished merely by increasing the hourly rates to adjust for inflation. We do not conclude this. On pages 19 and 21 of the report, we point out that the department's deputy director for planning and construction told us that the department negotiates a new set of rates for a contract amendment based on the contractor's current rates plus an allowance for inflation. Furthermore, we state on page 19 that the deputy director's explanation was not accurate. Table 3 on page 20 shows that the department negotiated increases to the billing rates of its program management contractor that exceeded the cost-of-living allowances awarded to state workers in eight of ten billing categories.
- (5) The agency correctly points out that the department's negotiators have not agreed to increases in the program manager's billing rates that equal the cost-of-living raises provided to state employees. Citing the increases in the program manager's billing rates from fiscal year 1984-85 to fiscal year 1985-86, the agency states that the increases were generally lower than the State's cost-of-living adjustments. We would like to put the agency's statement in perspective. From fiscal year 1984-85 to fiscal year 1985-86, increases in the program manager's billing rate ranged from 2.7 to 3.9 percent; however, from 1983-84 to 1984-85, the increases ranged from 16.4 to 56.3 percent.

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps